PACIFIC NORTHWEST ASSOCIATION OF INDEPENDENT SCHOOLS

What Makes Me a Fiscally Responsible Trustee?

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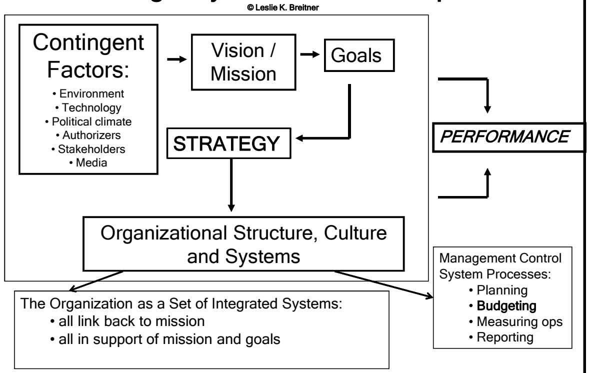
A Contingency Framework Perspective



Assess Financial Leadership

- Provide decision makers with timely and accurate financial information.
- Use the data to assess the financial condition of the organization's activities.
- Plan for meaningful financial goals.
- Communicate progress toward goals to internal and external stakeholders so they can…

FOLLOW THE MONEY

From Peters and Schaffer, 2005

Leadership Principles for Board Members

- Don't dwell on the tradeoffs between mission and money – they must be integrated concepts!
- Cultivate financial leadership on board as well as within staff.
- The nonprofit organization is a set of interdependent programs and activities. Identify core competencies!
- Recognize the relationship between a strong infrastructure and strong programs.
- Set the tone for financial accountability and transparency.

From Peters and Schaffer, 2005

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Financial Statements:

How do I tell the story of this organization from reading the financial statements?

- Interpret and use financial statements.
- Distinguish between accounting and financial management issues.
- Gain awareness of appropriate costs for financial decision-making.
- Develop ability to serve in positions of governance.
- Be able to communicate with funders or lenders, some of whom may be in the private sector.

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What Do We Want to Know?

Is the organization:

- Earning a sufficient surplus? (PROFITABILITY)
  - What is a surplus anyway?
  - Why is this important?
- Generating enough cash? (LIQUIDITY)
  - What is the timing of cash flows?
- Managing its assets well? (ASSET MANAGEMENT)
- Financing itself appropriately? (Long-Term SOLVENCY)
  - What are the sources of revenue?
  - Are they sustainable?
  - Is there debt? Enough? Too much?

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Fundamental Questions for Financial Analysis of Nonprofits

1. Are the organization's goals consistent with the financial resources it needs to finance them?
1. Is the organization maintaining intergenerational equity?
1. Is there an appropriate match between financial resources and their uses?
1. Are the current resources sustainable?

From Herzlinger and Nitterhouse, 1994

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Q1: Are the organization's goals consistent with the financial resources it needs to finance them?

- What's the relationship between ambition and competency?
- How do we measure organizational wealth?
  - Liquidity: ability to meet short-term obligations
  - Long-term solvency: organization's reliance on debt in its capital structure and its ability to repay it (with interest)
- What's the relationship of operating activity with respect to assets?
- Do financial resources affect the organization's mission inappropriately? Is the mission consistent with financial ability?

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Q2: Is the organization maintaining intergenerational equity?

- Is the organization maintaining purchasing power of its net assets?
- Do they use past savings to finance the present?
- Are they using the present to finance the future?
- Are net assets increasing more than the rate of inflation?

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Q3: Is there an appropriate match between financial resources and their uses?

- Match long-term with long-term and short-term with short-term.
- Long-term assets should be financed with long-term sources of capital – why?
- How stable and predictable are the sources of financing?

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Q4: Are the current resources sustainable?

- Dispersion of sources and uses of capital: the fraction of the total category accounted for by one activity in that category.
- Diversified sources of revenue.
- Is "tipping" a concern for the organization?
  - Tipping occurs when an organization receives so much support from so few sources that it is no longer considered a charity, but rather a private foundation.
  - Being "tipped" from a public charity to a private foundation can hinder the ability to carry out the mission.

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Use the <u>Three</u> Financial Statements

- The Balance Sheet: A Status Report
- The Operating Statement (Statement of Activities): A Flow Report
- The Statement of Cash Flows: Where did it come from? Where did it go?

Analyze:
Trend Analysis
Ratio Analysis

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Financial Statement Red Flags: *Quality of Earnings*

- Lack of diversity in revenue sources
- Relatively low current ratio (poor liquidity)
- Negative cash flow from operations (what does it mean?)
- Negative unrestricted net assets (what does it mean?)
- High administrative cost ratio
- Unexplained trends or budget variances
- Extraordinary events to achieve a surplus (unsustainable activities)

From E. Floyd (Moss-Adams LLP)

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Revenue Sources

Diversify across revenue streams.
Diversify within revenue streams.
Diversify with respect to cash flows.

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Concepts & Techniques

- Financial statements are accrual-based.
- Cash inflows and outflows are often different from revenues and expenses.
- Five critical financial management issues:
  1. Profitability
  2. Liquidity
  3. Asset Management
  4. Solvency
  5. Critical Success Factors

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Cash Flow, or Lack Thereof

Common misconception in the nonprofit sector:
Revenue must equal expenses every year.

If this were the case, the organization could never increase its assets and therefore never increase the stability of its capital structure.

It's the equivalent of telling individuals they have to spend all the money they make every year and not put any away in a savings account.

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What do the Funders Want to See?

Net Assets (Balance Sheet):
- Unrestricted
- Temporarily restricted
- Permanently restricted

Cash (Balance Sheet):
- Unrestricted
- Temporarily restricted
- Permanently restricted

Surplus/Gains (Operating Statement):
- Operating gains/losses
- Non-operating gains/losses

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Key Concept:

Nonprofits Need Surplus Too

[From David W. Young]

- Assist the organization to obtain funds necessary to replace assets that wear out or become obsolete *
- Generate sufficient cash to support organizational growth
- Provide the organization with funds necessary to expand and diversify its fixed assets as it expands activities
- Protect from fluctuations in revenues from year to year, and from uncertainties surrounding ongoing operations

**Socking away amounts equal to depreciation will leave you shortchanged at time of asset replacement (due to inflation). How does this work?*

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THREE OPTIONS FOR EARNING A SURPLUS

1. Reduce Expenses
2. Increase Revenues
3. A Combination of the Two

Board Decision:

Buy a new truck?

How do we decide?

REVENUES				
Fees for Service	$	25,000		
Campaigns		33,000		
Foundations and Corporate Matching		40,000		
Events		75,000		
Government Grants		80,000		
Individual Contributions		32,000		
Miscellaneous		500		
TOTAL REVENUES			$	285,500
EXPENSES				
Administration				30,000
Fundraising				35,000
Operations				
Capital Improvements (New truck)	$	42,500		
Operating Supplies		3,000		
Rent		9,000		
Repair & Maintenance		2,250		
Transportation		600		
Utilities		1,200		
Vehicle		3,750		
Operations Total			$	62,300
Personnel				
Staff Salaries	$	150,000		
Payroll Taxes		18,000		
Medical & Dental		14,000		
Other benefits		9,000		
Parking		1,200		
Personnel Total			$	192,200
TOTAL EXPENSES			$	319,500
SURPLUS (DEFICIT) Before Contribution from Reserves			$	(34,000)
From Reserves				
SURPLUS (DEFICIT)				

What's the value of accrual accounting?

Why depreciate your assets?

REVENUES				
Fees for Service	$	25,000		
Campaigns		33,000		
Foundations and Corporate Matching		40,000		
Events		75,000		
Government Grants		80,000		
Individual Contributions		32,000		
Miscellaneous		500		
TOTAL REVENUES			$	285,500
EXPENSES				
Administration				30,000
Fundraising				35,000
Operations				
Depreciation	$	8,500		
Operating Supplies		3,000		
Rent		9,000		
Repair & Maintenance		2,250		
Transportation		600		
Utilities		1,200		
Vehicle		3,750		
Operations Total			$	28,300
Personnel				
Staff Salaries	$	150,000		
Payroll Taxes		18,000		
Medical & Dental		14,000		
Other benefits		9,000		
Parking		1,200		
Personnel Total			$	192,200
TOTAL EXPENSES			$	285,500
SURPLUS (DEFICIT)			$	-

What is a surplus?

How do you get one?

REVENUES		
Fees for Service	$ 30,000	
Campaigns	33,000	
Foundations and Corporate Matching	40,000	
Events	75,000	
Government Grants	80,000	
Individual Contributions	32,000	
Miscellaneous	500	
TOTAL REVENUES		$ 290,500
EXPENSES		
Administration		25,000
Fundraising		35,000
Operations		
Depreciation	$ 8,500	
Operating Supplies	3,000	
Rent	9,000	
Repair & Maintenance	2,250	
Transportation	600	
Utilities	1,200	
Vehicle	3,750	
Operations Total		$ 28,300
Personnel		
Staff Salaries	$ 150,000	
Payroll Taxes	18,000	
Medical & Dental	14,000	
Other benefits	9,000	
Parking	1,200	
Personnel Total		$ 192,200
TOTAL EXPENSES		$ 280,500
SURPLUS (DEFICIT)		$ 10,000

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CASH NEEDS ASSOCIATED WITH GROWTH: Example

Assumptions:

1. Growth in revenue and expenses on a monthly basis.
2. Accounts receivable collection lag of two months.
3. Accounts payable paid immediately.
4. No surplus.

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CASH NEEDS ASSOCIATED WITH GROWTH

Operating statement:	---------------MONTH-------------					
Revenue	100	102	104	106	108	110
Expenses	100	102	104	106	108	110
Surplus	0	0	0	0	0	0
Cash collections	96	98	100	102	104	106
Cash payments	100	102	104	106	108	110
Change in cash	(4)	(4)	(4)	(4)	(4)	(4)
Cumulative	(4)	(8)	(12)	(16)	(20)	(24)

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FOUR OPTIONS TO FIX THE PROBLEM:

1. Speed up collection of receivables
2. Delay payment of expenses
3. Slow Growth
4. Earn a surplus (how much?)

Equal to the negative change in cash

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EXAMPLE: REDUCE EXPENSES BY 4 IN MONTH 3

Operating statement:

	--------------MONTH--------------					
Revenue	100	102	104	106	108	110
Expenses	100	102	100	102	104	106
Surplus	0	0	4	4	4	4

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THE SOLUTION: A SURPLUS OF 4

Option 1: Reduce Expenses

Operating statement:

	--------------MONTH--------------					
Revenue	100	102	104	106	108	110
Expenses	100	102	100	102	104	106
Surplus	0	0	4	4	4	4
Cash collections	96	98	100	102	104	106
Cash payments	100	102	100	102	104	106
Change in cash	(4)	(4)	(0)	(0)	(0)	(0)
Cumulative	(4)	(8)	(8)	(8)	(8)	(8)

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HOW IS THE ORGANIZATION MANAGING ITS LIQUIDITY?

Some ratios:

- Current ratio—a rough indicator, easily available
- Quick ratio—still rough but a bit better
- Average days receivable—managing collections
- Days cash: Cash balance ÷ Expenses/365

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HOW IS THE ORGANIZATION MANAGING ITS ASSETS?

Some ratios:

- Asset turnover—very macro
- Fixed asset turnover—a bit more focused
- Average days receivable—also helpful here

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HOW IS THE ORGANIZATION MANAGING ITS FINANCING?

Some ratios:

- Debt/Equity—very macro
- Long-term Debt/Equity—a bit more focused
- Leverage—a variation on debt/equity
- Debt-service Coverage —rough cash flow versus principal and interest payments

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Key Concept:

Financing Growth with Leverage

Leverage – The use of debt to purchase more assets than you can with only generated surpluses.

Advantages: grow faster, serve more, increase revenues

Disadvantages: interest fees, cash flow challenges, meeting debt service obligations

LEVERAGE ALLOWS AN ORGANIZATION TO HAVE MORE ASSETS ON THE BALANCE SHEET THAN EQUITY ALONE WOULD PERMIT. THEREFORE . . .

WHY NOT FINANCE AS MANY ASSETS WITH DEBT AS YOU CAN?

From E. Floyd (Moss-Adams LLP)

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What's Wrong with Leverage?

Financial Risk	Low (Business Risk)	High (Business Risk)
High	Possible	Danger Zone
Low	Very Safe	Necessary

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Surplus and Growth - Summary

Nonprofits need Surplus (profit):

1. Replace assets
2. Finance growth and/or diversify assets
3. Protect against uncertainties, fluctuations
4. Note that understanding cash flow is critical

Use of Leverage:

1. Increasing debt is an alternative
2. Debt has risks, advantages and disadvantages

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FOR YOUR ORGANIZATION

Is it:

- Earning a sufficient surplus?
- Generating enough cash?
- Managing its assets well?
- Financing itself appropriately?

How have things changed over the last three-years?

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Financial Accounting
Financial Management
Management Accounting

- Financial statements portray financial performance and position.
- Analysis of financial management issues informs strategic planning and organizational analysis. THIS IS THE LINK FROM AN HISTORICAL PERSPECTIVE TO FUTURE PLANNING!
- Knowledge of cost structure and behavior is imperative for effective management, operational budgeting, and everyday decision-making.

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Managerial Decision Making:
Decisions that Use Cost Data

- Pricing decisions require full cost information.
- Programming decisions require differential cost information.
- Revenue sources and resource allocation are critical to enhanced performance and organizational sustainability.
- Capital budgeting tools (discounted cash flow, payback) enhance analysis.
- Every managerial decision is a cost-benefit analysis.
- Use Social Return on Investment analysis (SROI) for evaluation purposes. This can be complicated!

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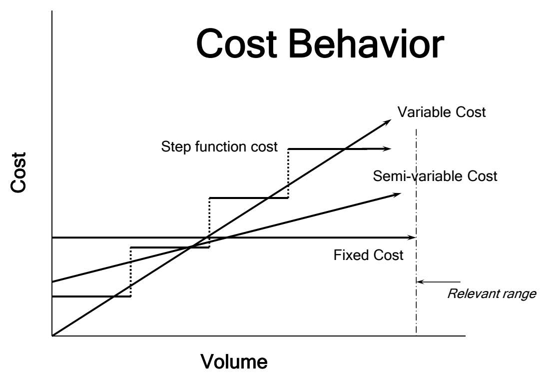
Can you classify your organization's costs?

	Direct	Indirect
Variable	Supplies Meals	Organizational Support Staff
Fixed	Program Director's Salary	Organizational Rent
	Traceable	Must Allocate

Cost Behavior



DIFFERENTIAL COSTS

- Costs used for certain decisions.
  - "Make/buy" decisions
  - Eliminate/add a program
  - Marginal cost decisions
- Which costs will be different in the new scenario?
- Which costs are irrelevant for this type of decision making?

Management Control System Processes

- Programming
  - Goal development
  - Linking goals to mission
  - Competing demands
  - Cost structure of organization with respect to individual programs
- Budgeting
  - Do we have the resources to do what we say we will do?
  - Do we have the management expertise to carry it out? The capacity?
- Measurement of operations
  - Flexible budgeting
  - Variance analysis
  - Development of indicators/measures
  - Link $$$ to the indicators; link back to mission and goals
- Reporting
  - Communicating the results to those who "need to know"
  - Who needs to know?

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The Budget

- Role of the budget (budget becomes policy!).
- The power of understanding the financial picture.
- Budgets looks forward; financial statements are historical.
- Is the budget the decision driver, or do strategic decisions drive the budget?
  - Money vs. Mission?
- Can you link the strategic plan with the budget?
- Can you link cost data for decision making with the budget?
- Do you analyze budget variances and compare with other budgets?
- Who are the key players in formulating the budget?
- Do you anticipate constraints posed by funders as you plan?

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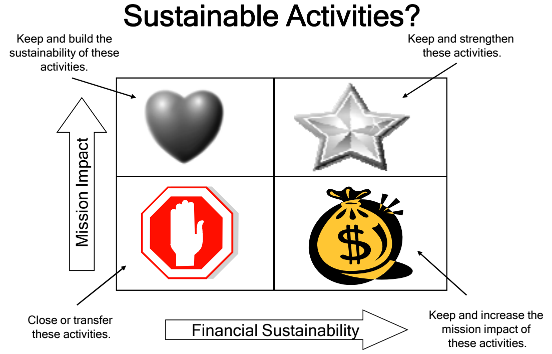
Sustainable Activities?



From Peters and Schaffer, 2005

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